

Moscow Financial Weekly

For the weeks ending August 29 and September 5, 12, and 19, 2003
Treasury Attache's office, U.S. Embassy Moscow

Highlights

- Deposit insurance bill passes in first reading
- CBR lifts capital controls on S-type accounts
- CBR proposes improved bank supervision procedures

Key Economic Indicators

Indicators	Level	% chg 1 week	% chg since Jan. 1
Ruble/\$ (MICEX) UTS	R30.5700	-0.20	-3.82
Monetary Base*	R1198.7 bln	0.94	27.48**
CPI	NA		8.3
International Reserves*	\$62.1 bln	0.16	30.19
RTS Index (end of week)	546.86	0.60	52.30
Refinancing rate	16	0	-23.8

*For week prior

** % chg from the abnormally high seasonal level at the end of the year.

Economic Developments

On September 19 the State Duma passed the **2004 budget bill** in the first reading. Although communists, Union of Right Forces and Yabloko voted against, the centrist majority provided 246 votes in favor of the bill. According to the bill, Federal budget revenues will total R2,742.85 billion (17.9% of GDP) and expenditures – R2,659.45 billion (17.4% of GDP). The balance in the amount of R83.4 billion will be transferred into the newly established stabilization fund. Defense, state security, state management, education and healthcare are to get bigger shares of total expenditures than in 2003 at the expense of other line items. The share of debt servicing is expected to drop from 11.7% of GDP in the 2003 budget to 10.9%. Amendments to the Budget Code providing for stabilization fund were passed in the first reading as well.

According to Ministry of the Economic Development and Trade (MEDT) data, **exports increased** by 28% and totaled \$72.7 billion during the first seven months of 2003. Imports increased by 20%, to \$39.2 billion, during the same period. The growth in exports was again most likely caused by high prices on world markets for oil and other natural resources. The increase in imports was stimulated by stable growth in domestic

For the weeks ending August 29 and September 5, 12, and 19, 2003

consumption and investments, but was somewhat tempered by the appreciation of the Euro against the U.S. dollar during this period.

The rating agency Moody's announced that the decision on the next increase of **Russia's sovereign debt rating** will be made in October. Stable macroeconomic indicators have made it possible to consider another upgrade. Some optimistic market participants hope that the rating will be increased to investment grade, but the agency will most probably increase the rating by only one grade, stopping one step below the investment-quality level, similar to the other rating agencies.

The **Purchase Managers' Index** (PMI) for **services** calculated by Moscow Narodny Bank increased to an all-time high of 62.6 points in August, compared to 61 in July. (A level above 50 indicates an increase of activity in the services sector.) The stable pace of growth in the index reflects an expansion in the Russian service sector despite weakening domestic demand. Results in the "business activity" index and "new orders" index suggest growing investment opportunities within the transport/storage and post/telecommunications sector. The current level of purchase orders and activity suggests that growth may continue through 2004.

Banking sector

July was the first month since February 2003 when Russian citizens stopped "getting rid of" **foreign currency** notes. Moreover, July saw a renewed interest on the part of individuals in cash dollars, accompanied by a weakening of their demand for euros. According to CBR statistics, the inflow of foreign currency in July amounted to \$1,007.1 million, which is 60.8% higher than in the previous month. U.S. dollars accounted for 68.3% of this inflow, while euro notes accounted for just 31.4%. Foreign currency outflow amounted to \$271.6 million, 68.1% less than in June, and 98.9% of that amount was in U.S. currency notes. Thus, June's net outflow of foreign currency of \$226.1 million in July was superseded by an inflow totaling \$735.5 million, of which \$419 million was in U.S. currency. Although such foreign currency inflows are one sign of capital flight, it is too soon to tell if the trend of net capital inflows seen earlier this year has reversed.

According to CBR Deputy Chairman Oleg Vyugin, the Committee for Monetary Policy of the CBR decided to introduce a series of **new refinancing instruments** with terms of seven days, two weeks and three months. This decision is subject to approval of the Board of Directors, which will also determine the limits for rates on these instruments. Vyugin expects that these instruments will be introduced in October and the rates will be "at market levels."

Effective September 15, the CBR practically eliminated restrictions on repatriation of foreigners' funds from **S-type accounts**. Now nonresidents may freely transfer securities from their investment (S-type) accounts to conversion accounts and subsequently repatriate the funds that were invested into corporate securities. Moreover, the CBR

eliminated any control over repatriation of interest and dividends on stocks bought with funds from S-type accounts, as well as the control over transfers of securities from one account to another. CBR Deputy Chairman Konstantin Korischenko expressed confidence that this liberalization will not result in an exodus of foreign investors from Russia.

On September 17, the Duma passed in the first reading the **deposit insurance bill**, the central piece of GOR's legislative package that is intended to establish a system of insurance of private deposits in Russia's commercial banks. The law is designed to protect primarily smaller to medium-size deposits: only deposits up to R95 thousand (equal roughly to \$3 thousand) will be covered in full. The functions of insurer are entrusted to the Agency for Restructuring Credit Organizations. Although Arkady Dvorkovich, Deputy Minister of Economic Development and Trade who is in charge of the package at the GOR, promised that the GOR would do all it could to ensure the bill is passed in all three readings during the current Duma session.

Depending upon their financial standing, between one-half and two-thirds of all Russian banks may become **participants in the new deposit insurance system**, according to Aleksey Simanovsky, CBR Department of Bank Regulation and Supervision Director, said. To become a member of deposit insurance system a bank has to submit application after which the CBR will start a comprehensive examination of this bank. It will evaluate the banks' financial standing, management system and business planning. If a bank does not pass the exam on the first try it will not lose its license immediately, and can be reviewed a second time. After the proposed two-year transition period (provided for in the current draft of the deposit insurance bill), all banks that take private deposits must meet the new CBR requirements or will lose their retail license.

In the second week of September Oleg Vyugin, CBR First Deputy Chairman, said in a newspaper interview that the CBR may liquidate two of its foreign subsidiaries, London-based **Moscow Narodny Bank** (MNB) and Paris-based **BCEN-Eurobank**, because their net asset value exceeds the market value of their businesses by at least \$200 million. Later the same day, as the interview was published, the CBR disavowed Vyugin's suggestion in an official press release stating that the CBR neither had considered, nor was planning to consider, liquidating either of the two banks. On September 15, talking to journalists, Vyugin revisited the issue, saying that the CBR has three options to choose from: 1) to sell the banks at market prices (in which case the buyers would be able to liquidate the banks themselves and gain considerably more than the purchase price), 2) simply withdraw net assets, thus saving the cost of liquidation, and 3) increase the value of the banks at least to respective net asset value while gradually replacing shareholders, and only after that divest completely. He added that the National Banking Council (NBC) plans to consider this issue on September 30, but if PriceWaterhouseCoopers has not completed its assessment of the banks by that time, the NBC's discussion may be postponed until a later date. On September 22, Vyugin told journalists that the long-awaited amendments to the Joint GOR-CBR Banking Strategy of 2001 should be finalized and made public in two weeks. In this new version, the deadline for divestiture from state banks would be moved from January 1, 2004, to January 1, 2005.

An international conference on **anti-money-laundering and terrorist financing issues** organized by the Association of Russian Banks, the Committee for Financial Monitoring (CFM) and the CBR took place in Moscow September 16-17. CBR Deputy Chairman Viktor Melnikov told the conference that in the first eight months of 2003, the CBR made 997 inspections of commercial banks, evaluating their compliance with money-laundering legislation and finding some violations in one out of three banks. 17% of these violations were related to technological problems, but over one-half were violations of reporting requirements to the CFM due to erroneous classification of transactions. Melnikov said that in 2002, the CBR applied penalty sanctions to 22 banks and revoked two banking licenses, and this year it has already penalized 34 banks. CFM Chairman Viktor Zubkov said that there are 170 credit organizations that have not provided a single report to the CFM. The CFM receives from 300 to 4,000 reports on suspicious transactions a day and has forwarded 13,000 reports to law enforcement agencies, which in turn originated 200 criminal cases.

On September 18, the CBR published on its web site a revised version of its main regulatory document, Instruction №1 for comment. The goal of this revision, according to CBR First Deputy Chairman Andrey Kozlov, is to facilitate “supervision based on a reasoned judgment,” in other words, moving from form to substance in **banking supervision**, and to eliminate window-dressing of financial reports. For this purpose the CBR demands that banks comply with mandatory norms on a daily basis, revokes five norms: N8 – risk per creditor (depositor), N9 – risk per shareholder (depositor), N11 – maximum for the total of attracted deposits, N11.1 – maximum for the total of liabilities to non-resident banks, and N14 – liquidity for transactions with precious metals and reduces the instant liquidity norm, N3, from 70% to 50%. Simultaneously with the proposed version of Instruction №1, the CBR posted on its website for comment updated guidelines on internal controls.

Financial markets

Forex Market

Although the four-week period starting from August 25 was one of ruble liquidity strain -- with interbank overnight loan rates at times surging over 25% -- demand for dollars most of the time remained high, and the dollar continued to appreciate against the ruble through the middle of the week of September 15. The CBR intervened periodically, in particular each time the exchange rate reached R30.7/\$; in the first half of September, it sold at least \$1.5 billion. On September 17, after two consecutive days of CBR interventions that were supported by a “verbal intervention” by First Deputy Chairman Vyugin, who warned banks that at the end of the month they might find themselves with no rubles to make mandatory payments, banks began to close long dollar positions. This trend was boosted by a weakening of the dollar on international forex markets.

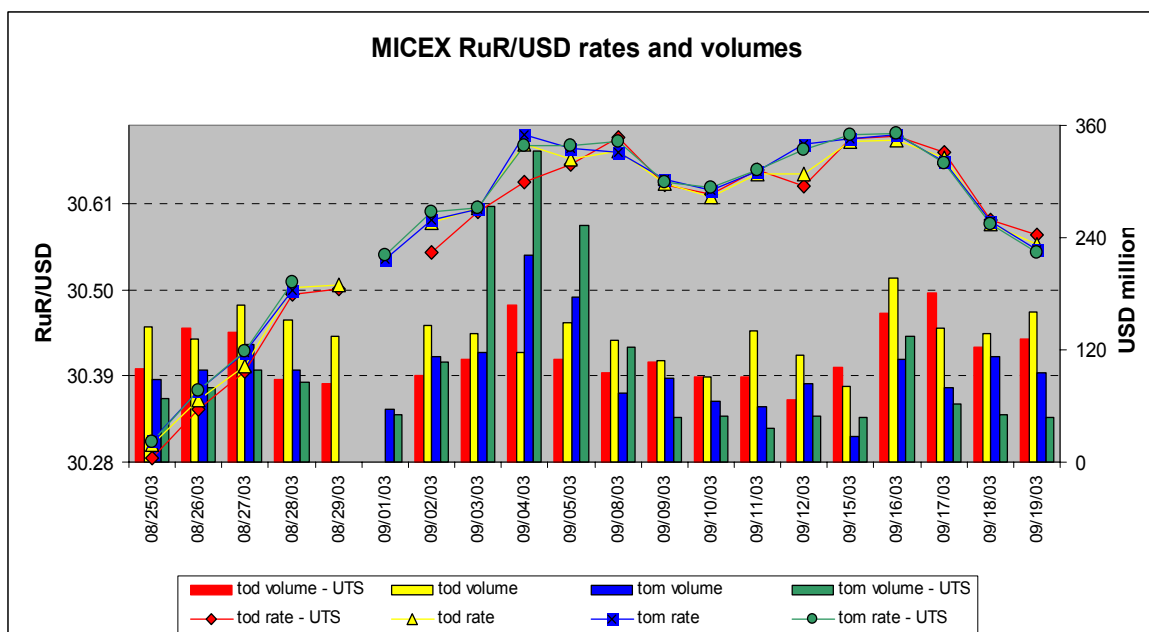
For the week of August 25, the ruble weakened against the dollar 0.63%, closing in the

For the weeks ending August 29 and September 5, 12, and 19, 2003

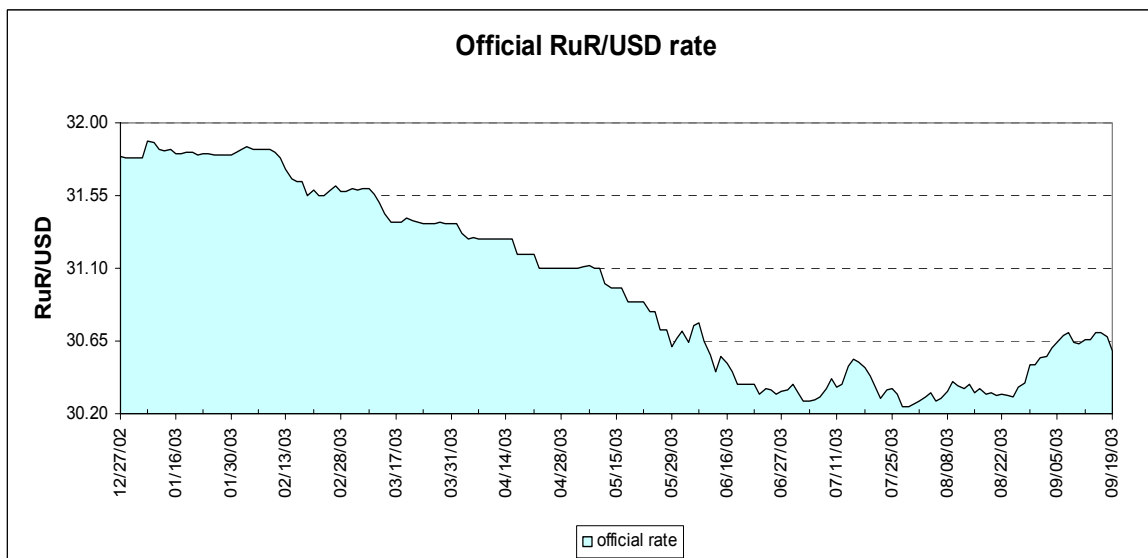
MOSCOW FINANCIAL WEEKLY

-5-

UTS on Friday at R30.5013/\$. MICEX weekly trade volumes were \$554.27 million and \$329.45 million, \$731.67 million and \$410.81 million for the UTS "tod" and "tom" sessions, and SELT "tod" and "tom" sessions, respectively. For the first week of September, the ruble weakened against the dollar 0.52%, closing in the UTS on Friday at R30.6607/\$. MICEX weekly trade volumes were \$479.96 million and \$1014.84 million, \$549.05 million and \$683.76 million for the UTS "tod" and "tom" sessions, and SELT "tod" and "tom" sessions, respectively. For the week of September 8 the ruble firmed against the dollar 0.09%, closing in the UTS on Friday at R30.6326/\$. MICEX weekly trade volumes were \$450.16 million and \$305.07 million, \$584.46 million and \$371.18 million for the UTS "tod" and "tom" sessions, and SELT "tod" and "tom" sessions, respectively. For the week of September 15 the ruble firmed against the dollar 0.20%, closing in the UTS on Friday at R30.5700/\$. MICEX weekly trade volumes were \$696.35 million and \$342.48 million, \$718.81 million and \$423.60 million for the UTS "tod" and "tom" sessions, and SELT "tod" and "tom" sessions, respectively.

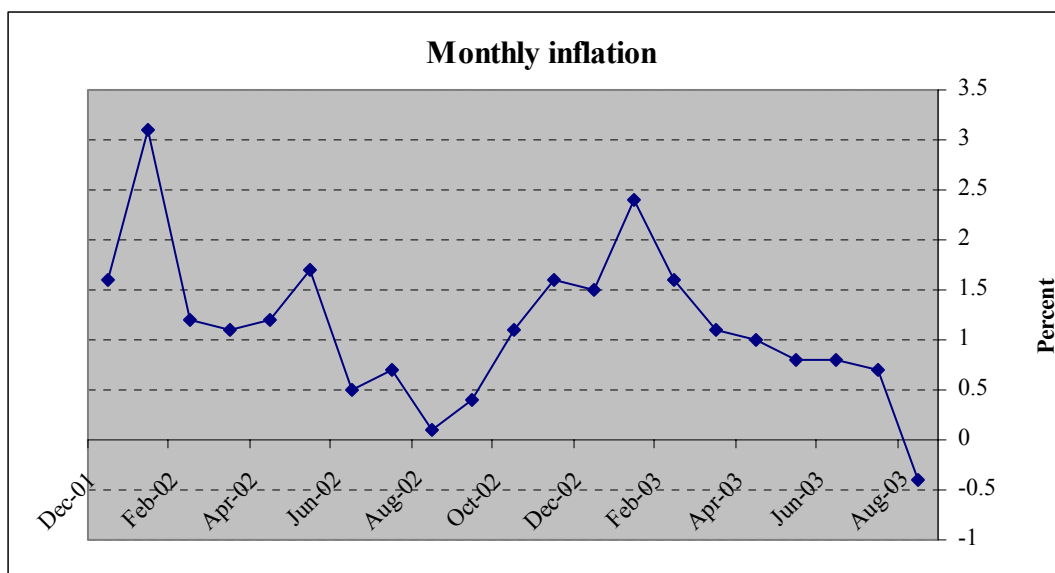


For the weeks ending August 29 and September 5, 12, and 19, 2003



Prices

According to Goskomstat data, Russia experienced deflation of 0.4% in August, which is the highest level of deflation measured in post-Soviet Russia. This was caused in part by a decrease in the prices of fruits and vegetables (by as much as 17.2%) for the month. Since the beginning of the year, prices have risen by 8.3% (vice 8.7% since July). The Russian government forecast for inflation in 2003 remains at 10 to 12%, and 8 to 10% for 2004.



For the weeks ending August 29 and September 5, 12, and 19, 2003

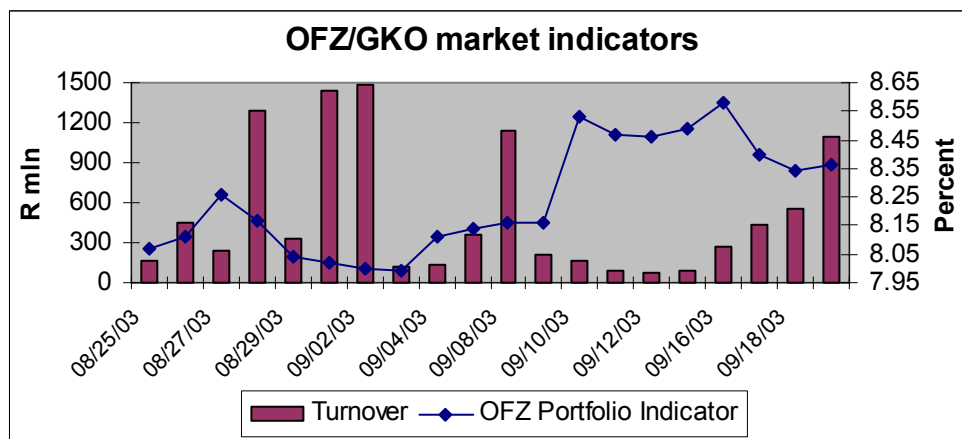
Eurobonds

Prices in the Russian Eurobond market were rising during much of the four week period observed. The most important driver of the market was the increasing prices of U.S. Treasuries. Also, spreads tightened due to increased attention to Russian Eurobonds from Russian players, who were switching to dollar-denominated instruments because of the depreciating ruble. Yields of the most liquid Russian paper, Euro-30, fell from 7.7 to 7.1% p.a. during the first three weeks observed and experienced only a slight downward price correction the week of September 15. Meanwhile the rest of the market did quite well, with yields finishing the week at new historic lows. News from Moody's about the re-evaluation of Russia's sovereign rating also added to the existing optimism of market players, driving the market prices up further.

Interest/Bond Market

Bonds/Bills

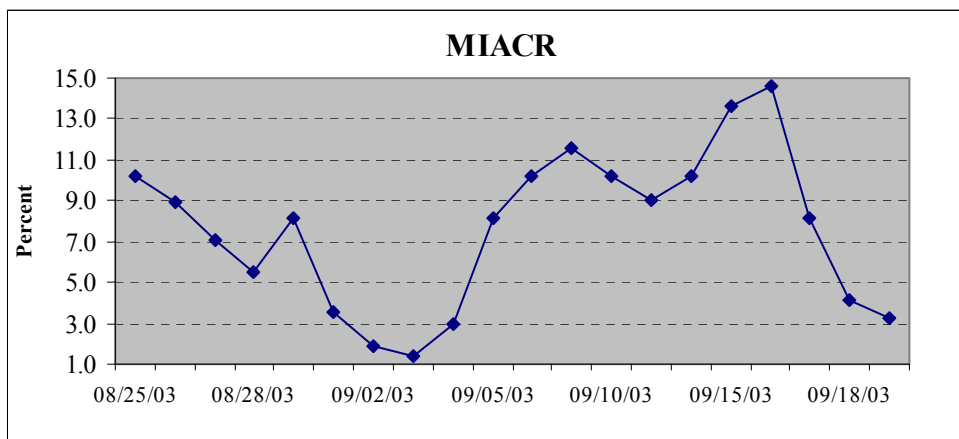
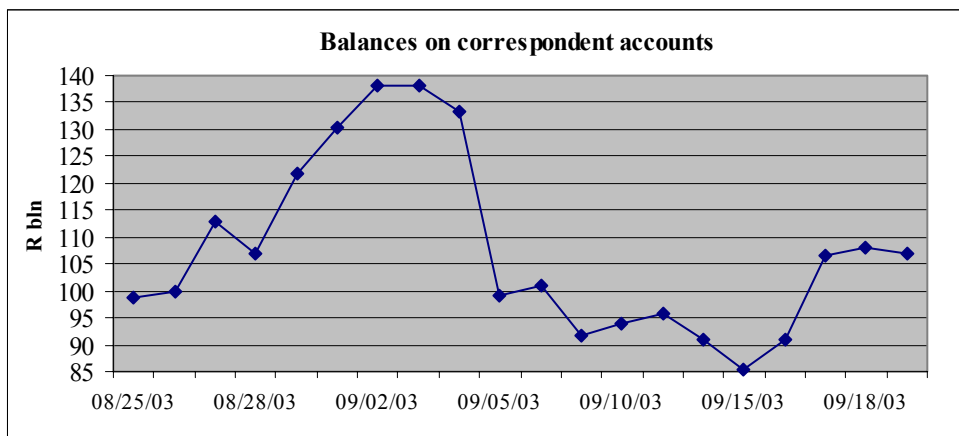
During the three weeks observed, prices on the secondary OFZ/GKO stumbled due to the weakening ruble and lowered ruble liquidity within the banking system. Last week the market was able to rebound on a wave of increased ruble quantity on banks' balances as well as redemption of OFZ instruments and several coupon payments made by the Finance Ministry, for a total sum of R13 billion. Trade volumes increased gradually and yields began to slide down.



Overnight rates

During the weeks of September 8 and 15, the market suffered from an acute shortage of rubles, with average daily balances on banks' correspondent accounts at the CBR standing at R97.1 billion. Balances fell to as low as R85 billion by September 15 -- the lowest level since March 2003. Interbank short-term ruble loan rates remained at higher

than average levels during the period observed, increasing to 14-17% p.a. in the middle of the month. The situation stabilized a bit from September 17-19, with balances exceeding R100 billion but still remaining at somewhat lower-than-average levels. The decreased liquidity can be attributed to the tensions on the currency market, i.e. ruble depreciation, causing banks to prefer staying long in USD.

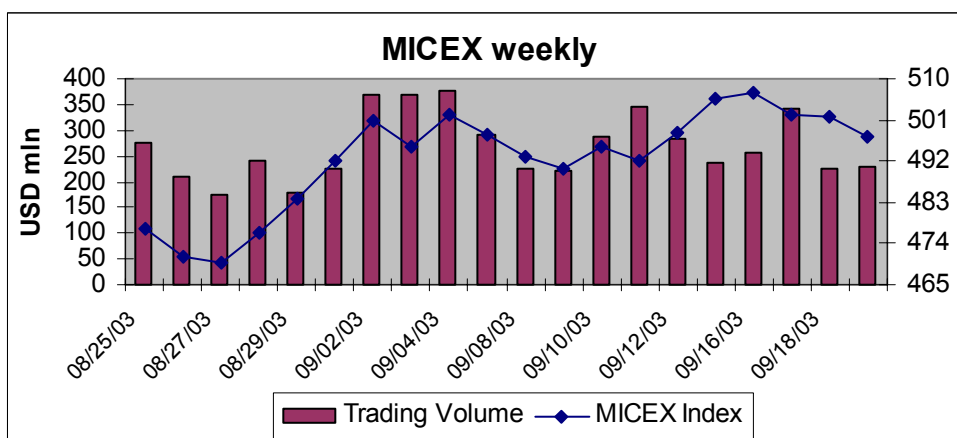
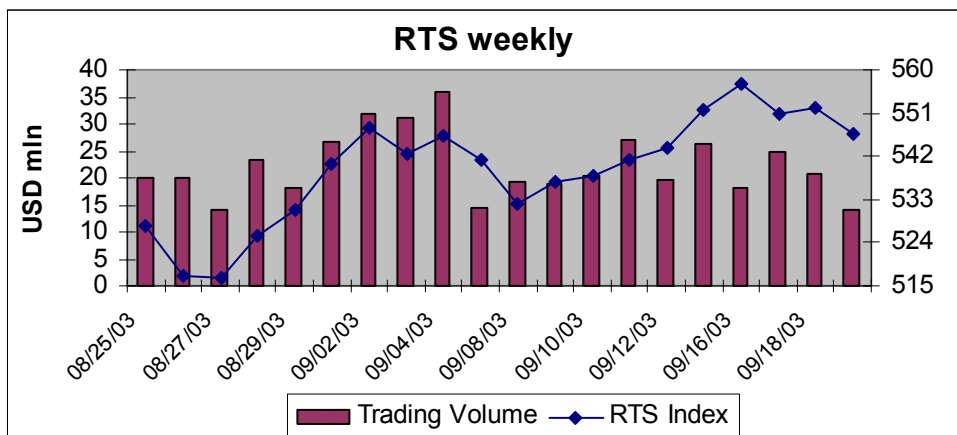


Stock Market

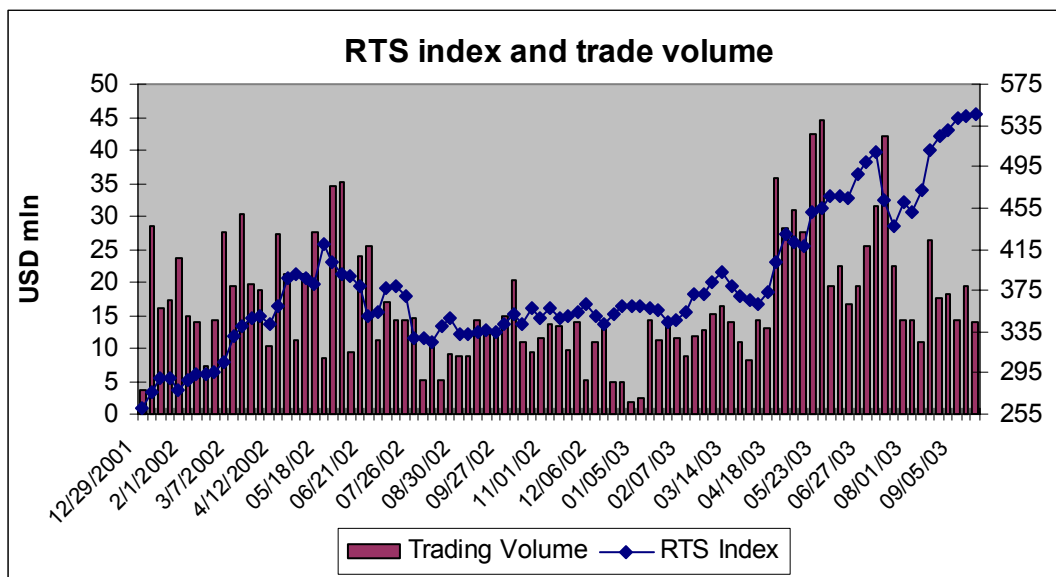
The Russian stock market rose throughout the four weeks observed, capping a period of seven weeks' continuous growth. During the last week of August, oil shares were one of the main factors pushing the market up, but during the following two weeks these shares weakened due to decreased oil prices and the fact that the shares had been considerably overbought. RAO UES shares were a locomotive of the market during the first two weeks of September, with only a minor downward correction supported by strategic investors. Another unquestioned leader during the past several weeks was GMK Norilsk Nickel, which has been stimulated by high world metal prices as well as the company's success at the auction for Lenzoloto. One of the main forces cooling the market slightly

For the weeks ending August 29 and September 5, 12, and 19, 2003

was the shortage of rubles on the market during the period observed. Nevertheless, for the four weeks under the consideration, the RTS index was able to gain 3.83% in dollar terms, reaching another six-year maximum.



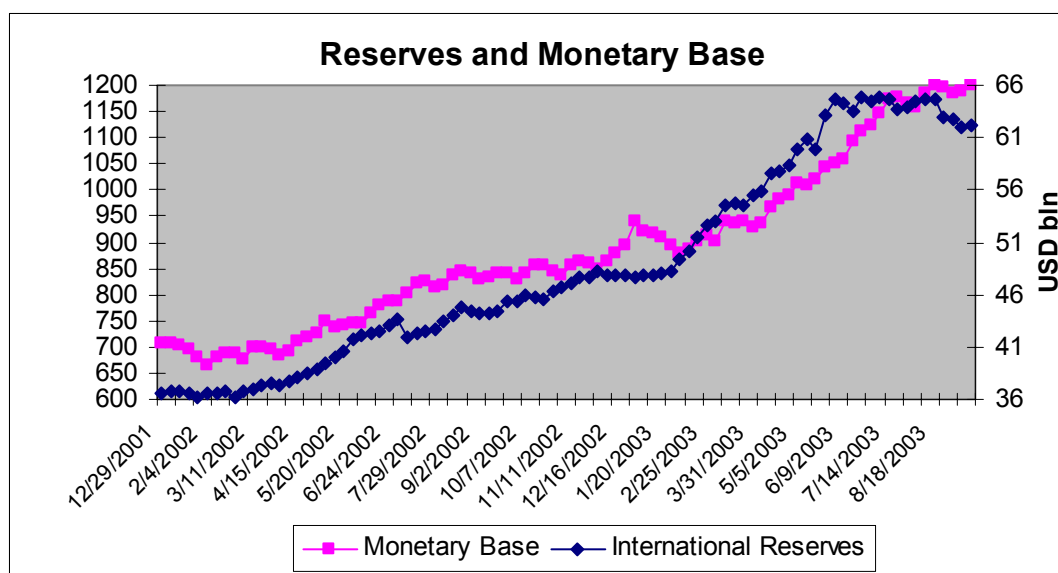
For the weeks ending August 29 and September 5, 12, and 19, 2003



International Reserves and Monetary Base

International reserves fell continuously throughout the period, down from \$64.7 billion in mid August to \$62 billion as of September 5. The decrease is attributed to high external debt payments as well as CBR interventions on the currency market. By September 11, reserves were able to gain a modest \$100 million, stopping the prolonged slide.

The monetary base fell during the last week of August, but it resumed its growth at the beginning of September. By September 15, it had reached R1,198.7 billion, which is the highest level ever reached. Since the beginning of the year the base is up by 27.48%.



For the weeks ending August 29 and September 5, 12, and 19, 2003

EXPLANATORY NOTES

1. EXCHANGE RATES: SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). MICEX Unified Trading Session (UTS) is the one in which exporters have to sell 50% of the repatriated currency. UTS "tom" weighted average as of 11:30 becomes the "official" exchange rate for the next day. "\$-tod" price is the price of the dollar with same day delivery. "\$-tom" is the price of the dollar with delivery on the next day. Minimum lot size for each of the dollar instruments is \$100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

2. INTEREST RATES: Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

3. STOCK INDICES: The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

4. INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities, repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

5. MONETARY BASE (M1) is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

6. LOMBARD CREDITS, distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.